NOS. 536 AND 535.

Supreme Court of the United States,

OCTOBER TERM, A. D., 1921.

THE NEW YORK TRUST COMPANY and another, Executors of WILLIAM L. HARKNESS, deceased,

Plaintiffs-in-Error,

vs.

WILLIAM H. EDWARDS, Collector of Internal Revenue,

Defendant-in-Error.

JOHN D. ROCKEFELLER,

Plaintiff-in-Error,

vs.

UNITED STATES OF AMERICA,

Defendant-in-Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

Reply Brief for Plaintiffs-in-Error.

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IN THE

Supreme Court of the United States

October Term A. D., 1921

THE NEW YORK TRUST COMPANY and EDITH HALE HARKNESS, Executors of the Last Will and Testament of William L. Harkness, deceased, *Plaintiffs-in-Error,* *against* WILLIAM H. EDWARDS, Collector of United States Internal Revenue for the Second District of the State of New York, *Defendant-in-Error.*	No. 536.
JOHN D. ROCKEFELLER, *Plaintiff-in-Error,* *against* UNITED STATES OF AMERICA, *Defendant-in-Error.*	No. 535.

REPLY BRIEF FOR PLAINTIFFS-IN-ERROR.

There is no constructive argument in the Government's brief which requires a reply. However, since our main brief assumed that the Government would address itself to the merits of the case, and it appears from its brief that it purposes not to do so, but to confine itself

to form and technicalities, it is believed that a few words in reply will help to clarify the issue.

I.

The Government's brief entirely disregards the substance of the transaction and deals only with technical matters of form.

This Court said in the *Macomber* case that "regard must be had to the very truth of the matter, to substance and not to form." Accordingly, in our main brief we called attention to the fact that the transaction must be viewed as an entirety, and that so viewed it consisted of a transfer of the pipe line properties to the pipe line companies by reason of business necessity, and the issue or distribution to the stockholders of the oil companies of the stock of the pipe line companies, in order that their interest in the entire enterprise might be preserved. The Government on the contrary, disregards the effect of everything which preceded the issue or distribution of the stock of the pipe line companies, and attempts to give the transaction the aspect of one which involves nothing except the distribution of property to stockholders.

So complete is the Government's absorption in technicalities of form that it apparently misunderstands our argument that as a result of the transaction nothing was freed from corporate control and business risks and transferred to the absolute ownership of the stockhold-

er. The Government says, at page 16 of its brief, that our argument amounts to a contention that whenever a stockholder receives as a dividend shares of stock in another corporation he does not receive income simply because the shares of stock are subject to the corporate control of the company which issues them. We make no such contention. When we argue that nothing was separated from corporate control and business risks we refer of course to the pipe line properties, and not to the stock of the pipe line companies. It is difficult to understand how our argument could have been misunderstood, because in making it we clearly stated, as, for example, at page 55 of our main brief, that we were referring to the pipe line properties.

Apparently we are talking about one thing—the substance, and the Government is talking about another thing—the form. This Court has said that "regard must be had to * * substance and not to form."

The viewpoint of the Government is illustrated by its concession at page 14 of its brief, that if the oil companies had held the stock of the pipe line companies the transaction would have been one with respect to which no tax could have been claimed, and its further concession that if thereafter a stock dividend capitalizing the surplus had been issued no tax would have been payable. If it had not been for the lack of power of The Prairie Oil & Gas Company to hold the stock of the pipe line company, and the possibility of technical objection by State and Federal Commissions if The Ohio Oil Com-

pany did so, the stock of the pipe line companies might very well have been held by the oil companies, and everything which the oil companies sought to and did accomplish by the transaction involved in the case at bar would have been accomplished. It is clear, therefore, that the Government does not claim that there was anything in the substance of what the oil companies accomplished which properly renders their stockholders taxable, and that it is only on account of the necessary technicalities and formalities of the particular transaction that a tax is sought to be imposed.

II.

The Government's assertion that the oil companies characterized the issue or distribution of the stock of the pipe line companies as "dividends" is unwarranted by the facts in the record.

It appears in the record that the practice of both of the oil companies was to charge to dividend account the amount of all dividends paid, and that in connection with the particular transaction no entry was made in the dividend account of either of the oil companies. (No. 535, Rec. Fols. 21, 28; No. 536, Rec. Fols. 11, 18.) In the case of The Prairie Oil & Gas Company the transfer of the pipe line properties necessitated that there be charged off through profit and loss account the sum of $27,000,000. The Government says, at page 8 of its brief,

that this sum represented the value of the stock of the pipe line companies. It did not. The stock of the pipe line companies had never been entered as an asset of The Prairie Oil & Gas Company. It represented the book value of the pipe line properties. In the case of The Ohio Oil Company, the stock of the pipe line companies was taken up on its books. It was, therefore, necessary to carry it out through profit and loss account. The entry was there designated "dividend." It was obviously so called simply because it was desired to give some explanation of the entry in the profit and loss account, and that seemed a convenient way to do it. If it had been regarded by the company as a dividend it would of course have been carried through the dividend account.

The only importance which we attach to the fact that the oil companies did *not* characterize the issue or distribution of the stock of the pipe line companies as "dividends" is that it completely disposes of the argument made at page 20 of the Government's brief, that whenever property is distributed as a dividend it must constitute a distribution of surplus. The fact being that the oil companies did not characterize the issue or distribution of the stock of the pipe line companies as dividends, the character of the property distributed determines whether it is capital or surplus, and since on the Government's own theory the property distributed was the stock of the pipe line companies received upon the transfer of the pipe line properties, the distribution was on principle and under the authorities a distribution of capital—

not because it was stock but because it was the proceeds of the disposition of business plant constituting an integral part of the enterprise.

III.

The Government disregards entirely the fundamental distinction between the distribution to stockholders of mere liquid treasury assets on the one hand, and, on the other hand, the proceeds of the disposition of business plant constituting an integral part of the enterprise.

The Government asks, at page 21 of its brief, whether there is anything more liquid than a share of stock that can be sold on ten minutes' notice to a stockbroker. There is at least one thing which is more liquid, and that is cash, and it was cash which was distributed to the stockholders in the life tenant and remainderman cases referred to under Point Four in our main brief. The real inquiry is not the nature of the particular property transferred, but how it was acquired, and the authorities are unanimous that when an integral part of a business enterprise is sold and the proceeds, whether cash or stock or anything else of value, are distributed to the stockholder, that distribution is not a distribution of surplus or of income, but is a refundment to the stockholder of all or a part of his capital investment.

The Government states that the life tenant and re-

mainderman cases are not analogous to the case at bar. This Court said, in *Towne* vs. *Eisner*, 245 U. S. 418, at page 426:

> "Notwithstanding the thoughtful discussion that the case received below we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman. What was said by this Court upon the latter question is equally true for the former."

IV.

The Government exaggerates the significance of a stock certificate itself as distinguished from what it represents.

Throughout the briefs of the Government in the *Phellis* case and in the case at bar there runs the conception that so long as a stockholder retains his stock certificates and the corporation retains its franchise, nothing else matters. This misconception is the reason for the emphasis which the Government places upon the retention by the stockholders of the oil companies of their stock in those companies. Thus at page 12 of its brief in the case at bar, the Government, in an effort to persuade this Court that the case at bar is its stronger case, admits that if in the *Phellis* case the du Pont Powder Company had proceeded to liquidate its affairs and dissolve as a corporation "a more serious question would have arisen," and then states "upon that ques-

tion I need not express any opinion, for there was no liquidation or impairment of capital." Apparently the Government's theory is that there can be no liquidating dividend in the sense that what the stockholder receives is capital, not income, unless the capital stock is reduced. When the question is whether the result of a distribution to stockholders is the receipt of income or a refundment of capital, the fact that there has been no retirement of stock is not conclusive that the distribution constitutes a receipt of income. The stockholder's capital interest is liquidated just as completely if all of the assets of the corporation are transferred to the stockholders although he retains his stock (which, of course, has become worthless because the corporation owns nothing), as if he surrenders his stock for retirement. The question whether the stockholder has received income on his capital investment, or a refundment of that capital investment, cannot depend upon the technicality whether he remains the owner of a worthless stock certificate or surrenders it for cancellation.

Because the stockholders of the oil companies continued to hold all of their certificates of stock, the Government would have us believe that the fact that the oil companies no longer owned the pipe line properties which had theretofore constituted in the one case a quarter, and in the other case a half, of their income-producing assets, is of no significance whatever. Perhaps it is not, for purposes of form and technicality; but for purposes of truth and substance it is a matter of the first importance.

V.

The Government misconceives the entire issue in assuming that it need only establish that the pipe line companies were separate and distinct corporations and that the stock of those companies was received by the stockholders of the oil companies.

The Government's chief contention appears to be that, since the stock received by the stockholders of the oil companies was the stock of other corporations, the transaction was not a typical stock dividend, and it takes for granted that that is all that it is required to show in order to establish its case. It assumes that in the *Towne* and *Macomber* cases nothing was decided—no principle laid down—no precedent established—except that the capitalization of surplus by the issue of a stock dividend does not constitute the receipt of income by the stockholders.

In the *Towne* and *Macomber* cases this Court did something more than establish the applicability of certain fundamental principles of corporation law to the precise case of the issue of a stock dividend—it established the applicability of those principles to the entire system of income taxation. The principles to which we refer are the principles that (1) the interest of a stockholder is a capital interest with respect to the surplus as well as the capital of a corporation, and (2) that earnings of a corporation remain corporate property, unless and until distributed to the stockholders.

In *People ex rel Union Trust Co.* v. *Coleman,* 126 N. Y., 433, it was held that in determining the value of the "capital stock" of a corporation for purposes of taxation it was not proper to take the aggregate market value of all of its outstanding shares of stock. The New York Court of Appeals said, at page 437:

> "The capital stock of a company is one thing; that of the shareholders is another and a different thing. That of the company is simply its capital, existing in money or property, or both; while that of the shareholders is representative, not merely of that existing and tangible capital, but also of surplus, of dividend earning power, of franchise and the good will of an established and prosperous business * * * So that the property of every company may consist of three separate and distinct things, which are its capital stock, its surplus, its franchise; but these three things, several in the ownership of the company, are united in the ownership of the shareholders. The share stock covers, embraces, represents all three in their totality, for it is a business photograph of all the corporate possessions and possibilities."

In *Gibbons* v. *Mahon,* 136 U. S. 549, which involved the question of the rights of life tenant and remainderman in stock issued as a stock dividend, Mr. Justice Gray, speaking for this Court, said, at page 558:

> "Money earned by a corporation remains the property of the corporation, and does not become the property of the stockholders, unless and un-

til it is distributed among them by the corporation. The corporation may treat it and deal with it either as profits of its business, or as an addition to its capital. Acting in good faith and for the best interests of all concerned, the corporation may distribute its earnings at once to the stockholders as income; or it may reserve part of the earnings of a prosperous year to make up for a possible lack of profits in future years; or it may retain portions of its earnings and allow them to accumulate, and then invest them in its own works and plant, so as to secure and increase the permanent value of its property."

In *Eisner* v. *Macomber,* 252 U. S. 189, this Court said, at page 208:

> "Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. * * * Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company."

After referring to the bookkeeping entries incidental to the retention of profits by the corporation, this Court said, at page 209:

> "None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any par-

> ticular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose."

Again, at page 219, it said that "what is called the stockholder's share in the accumulated profits of the company is capital, not income," for the reason that "a stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation, prior to dividend declared."

The result of the application of these principles in the *Towne* and *Macomber* cases to the system of income taxation was to establish the rule that the stockholder must pay a tax when he actually receives for his own use and benefit a distribution of corporate earnings, or when he realizes a gain or profit upon a sale of his stock, but that until then he is not to be taxed upon any metaphysical theory that the accumulation of earnings by the corporation constitutes income to the stockholder.

The primary reason that the principles of corporation law referred to were held by this Court to be applicable to questions of income taxation is that those are the very principles upon which was based the system of taxaation established by the Income Tax Law of 1913 and continued in effect by the subsequent statutes. Under that system the corporation is taxed on its earnings. The stockholder is not taxed on the earnings of the corporation but only on such portion thereof as is dis-

tributed to him in the form of dividends. The system recognizes the propriety of the retention of earnings by the corporation and their investment in increased works and plant, subject to the limitation contained in Section A, subdivision 2, of the Act of 1913, that earnings fraudulently so retained for the purpose of exempting the stockholder from taxation shall be treated as part of the income of the stockholder.

This system is economically sound. The taxation of corporate earnings is logical, simple and convenient. The payment of the tax by the corporation properly secures an exemption from the normal tax of that portion of the earnings subsequently distributed to the stockholder, but the principle of sliding scale rates in the taxation of individual incomes requires that the stockholder pay the surtax thereon, and, of course, the stockholder's gain or profit on the sale of his stock is subject to both the normal tax and the surtax. Corporate earnings, other than those fraudulently retained in the business, should not be subjected to further taxation. The retention of those earnings stimulates industry and renders possible greater corporate earnings, which will in turn be taxed in the hands of the corporation, and larger dividends, which will be taxed when received by the stockholder.

The further principle of income taxation, that both corporate earnings and individual income shall be taxed as of the year of realization, has been of the utmost importance in recent years because the rates for almost every year have varied according to the fiscal needs of the Government.

Bearing in mind these fundamental principles of taxation recognized by Congress and by this Court, and disregarding technicalities, fiction and metaphysics, which of the three policies with respect to the treatment of earnings mentioned in *Gibbons* v. *Mahon* did the oil companies adopt? Did they (1) distribute earnings at once to the stockholders as income, or (2) reserve earnings of one year for possible distribution in future years, or (3) invest earnings in works and plant so as to secure and increase the permanent value of the properties? Clearly enough, the oil companies adopted the third policy and invested earnings in works and plant—treated them as an addition to capital.

What was there done to effect a change in that policy, to take the earnings out of works and plant—out of the business—and to give them to the stockholders? The Government says it was the transfer of the pipe line properties and the issue or distribution of the stock of the pipe line companies to the stockholders of the oil companies. Our reply is that that transaction did nothing of the sort, that its only effect was that the earnings remained in works and plant owned by, and in businesses conducted by, two separate corporations instead of by a single corporation, and that the capital interest of the stockholder was converted from a capital interest in a single corporation owning all of the works and plant and conducting both of the businesses, into a capital interest in two corporations, each of which owned a part of the works and plant and conducted one of the businesses.

What really happened was that the oil companies during the years preceding and including 1915, consistently pursued the policy of retaining a considerable portion of their earnings for purposes of increasing their works and plants. There was nothing in that which was in any way a fraud upon the tax system or an evasion of taxation. In 1915 it became necessary that a part of the works and plants should be transferred to newly organized corporations. This transfer was made with no intent to escape or decrease taxation. The earnings which had been retained in the business remained in the business.

The point which the the Government emphasizes is that th stockholders retained their original stock and received new stock. If the transfer of the properties had not been necessary, and the surplus had been capitalized by the issue of a stock dividend, the stockholders would equally have received new stock, and it is recognized that that would not have constituted income or subjected them to taxation. The Government admits that if the stock of the pipe line companies had been held by the oil companies the transaction would not have been taxable. It is clear, therefore, that there has been no subterfuge. The corporations continued in business, using as capital the former earnings retained in the business to produce increased earnings, upon which excess profits taxes were paid, and paying dividends to the stockholders, upon which they in turn paid surtaxes at the highest rates in history.

Shall it be said that the stockholder received as income

in 1915 the surplus which in all common sense obviously remained in the business to produce the earnings upon which excess profits taxes were payable, and dividends upon which war taxes were imposed? Shall we lose sight of the fact that the position of the stockholder remained substantially unaltered by reason of the transfer of the pipe line properties made in 1915?

The correct solution of the problem is that the only effect of the transfer of the pipe line properties and the issue or distribution of the stock of the pipe line companies was to alter the form of the capital interest of each stockholder of the oil companies, that our system of taxation leaves such a transaction untaxed, and that its entire purpose and design is accomplished in taxing the oil companies and the pipe line companies upon their earnings, and the stockholder upon his true dividends and any gain or profit realized when he sells his stock.

In the case at bar we find that the Bureau of Internal Revenue is endeavoring, upon a basis of the purest fiction and artificiality, to tax stockholders upon corporate earnings which have not in fact and in substance been distributed to them, but which have, on the contrary, been retained in the business. The Bureau of Internal Revenue cannot deny that as a practical matter the earnings were retained in the business, but it asserts that a tax is due from the stockholders because a part of the works and plant of that business was transferred to a newly organized corporation. It needs no argument to demonstrate that, as a matter of principle and the proper enforcement of our tax laws, that is no basis for such an assertion.

The outstanding feature of the decisions in the *Towne* and *Macomber* cases is that they recognize the fundamental principles of our system of taxation, that the stock holder pays when he realizes his income and not before, and that when a corporation has kept its earnings in the business the fact that those earnings have been capitalized by the issue of additional stock will not be allowed to serve as an excuse for a departure from sound principles of the law of corporations and our system of taxation. Clearly, there was better excuse for the disregard of these principles in a case in which the corporate act consisted of the capitalization of surplus transferred to capital account, than in a case in which the corporate act consists of the capitalization of works and plant, constituting a distinct and integral business, by the transfer thereof to a newly organized corporation.

In its attempt to establish that the *Towne* and *Macomber* cases have no bearing because in the case at bar new corporate entities were created, the Government overlooks entirely the fundamental consideration that a stockholder's interest in the surplus as well as the capital of the corporation is a capital interest, that it can cease to be such a capital interest only by virtue of some act of the corporation calculated to convert the surplus from corporate property dedicated to the business, into the individual property of the stockholder subject to his absolute use and disposition, and that in the case at bar every feature of the transaction compels the conclusion that the last thing which the oil companies desired or in-

tended was that any corporate assets, be they termed capital or surplus, should be taken out of the business and put into the hands of the stockholders.

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